

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:WR:CCA:SJ:TL-N
JYChinnapongse

date: JAN 25 1999

to: Chief, Examination Division, Central California District
Attn: Saul Ruiz, Revenue Agent

from: District Counsel, Central California District, San Jose

subject: [REDACTED]
TL-N-3618-95

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This is in confirmation and in furtherance of our conversation on January 6, 1999, regarding your request for advice with respect to the examination of [REDACTED] (" [REDACTED] ").

ISSUES

As we understand, at this time, you would like our advice as to the following:

- (1) Whether [REDACTED] received advance payments from its customers in taxable year one for services to be performed by the end of taxable year two (the next succeeding taxable year), or whether said payments represent part of the purchase price of computer equipment [REDACTED] sold to its customers.
- (2) If [REDACTED] did receive Advance Payments, is [REDACTED] eligible to defer the inclusion in gross income in taxable year one of such payments under Rev. Proc. 71-21.

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FACTS

████ sold, leased and serviced computers and related equipment in the ordinary course of its business. From the amount it received from a customer for the sale of computer equipment, █████ considered a portion to be an advance payment for the first twelve months of maintenance services. █████ determined that the advance payment for maintenance services was eligible for income deferral under Rev. Proc. 71-21 and recognized that income on a straight-line ratable basis over the twelve-month period. You have obtained and provided us with copies of the documents in the file for an █████ customer that purchased computer equipment from █████ and indicated that the documents generated for this customer are typical for all █████ customers that purchased computer equipment from █████.

The documents provided for the sample customer are:

1. Award/Bid Cover Sheet.
2. Master Maintenance Agreement Equipment Schedule (without the referenced Master Maintenance Agreement).
3. Commission Worksheet.
4. Acceptance Certificate.
5. A UCC document.
6. Initial Customer Support Agreement.
7. Performance And Support Agreement with exhibits including a document entitled Availability Warranty/Maintenance Credit.

Based on the above-stated documents and information you provided, this customer purchased computer equipment from █████, paid \$██████ to █████, and accepted the Master Maintenance Agreement Equipment Schedule (Equipment Schedule)¹ all in or around █████.

The Equipment Schedule separately itemizes monthly and extended monthly maintenance charges but does not specify the applicable period for either. The monthly and extended monthly maintenance charges listed however are the same, totaling

¹Although is not clearly reflected in the Equipment Schedule, we presume that the customer accepted the Equipment Schedule in or around █████ since █████ accepted the Equipment Schedule in █████.

\$[REDACTED] per month. The Equipment Schedule also contains the following statement:

THIS EQUIPMENT SCHEDULE IS HEREBY INCORPORATED INTO AND MADE PART OF THE ABOVE-REFERENCED MASTER MAINTENANCE AGREEMENT. PROVIDED CUSTOMER IS NOT IN DEFAULT OF THE MASTER MAINTENANCE AGREEMENT, THE TOTAL ON THIS PAGE SHALL BE WAIVED BY [REDACTED] FOR A PERIOD OF [REDACTED] MONTHS FOLLOWING THE COMMENCEMENT DATE OF THIS SCHEDULE.

As stated, we do not have a copy of the referenced Master Maintenance Agreement. Further, the Equipment Schedule does not mention the \$[REDACTED] or any prior remittance and does not specify whether and when any maintenance charge had been paid.

The sample Availability Warranty/Maintenance Credit Exhibit expressly provides in part that [REDACTED] warrants the computer equipment for [REDACTED] months, and, that, if the availability of the equipment fell below [REDACTED]%, [REDACTED] will repair the equipment, replace any defective component equipment or replace the equipment or any component or part thereof at [REDACTED]'s option. The warranty document further states that the customer is entitled to a credit of the monthly maintenance charge owing to [REDACTED] for each percentage point by which the equipment failed to meet the [REDACTED]% level and conversely that [REDACTED] is entitled to a setoff against any such maintenance credit for each percentage point by which the equipment's availability exceeded the [REDACTED]% level.

Based on your review of [REDACTED]'s financial records, [REDACTED] considered a portion of the \$[REDACTED] received from this customer to be an advance payment for twelve months of maintenance services. Specifically, [REDACTED] considered \$[REDACTED] representing the total monthly maintenance charge reflected in the Equipment Schedule for twelve months, to be an advance payment for those services. [REDACTED] determined that the advance payment was eligible for income deferral under Rev. Proc. 71-21 and recognized that income on a straight-line ratable basis over the twelve-month period. We do not have information but presume for the purpose of this opinion that [REDACTED] fully performed the twelve months of maintenance services on the computer equipment listed in the Equipment Schedule.

DISCUSSION

The purpose of Rev. Proc. 71-21 is to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income of "payments received"² in a taxable year for services to be performed by the end of the next succeeding taxable year. [REDACTED] contends it received an advance payment from each customer for the

²For purposes of the revenue procedure, amounts due and payable are treated as payments received. Hence, the references in this opinion to "payments received" include amounts due and payable.

first twelve months of maintenance services in taxable year one and that the advance payment was eligible for income deferral under Rev. Proc. 71-21. You believe [REDACTED] provided the twelve months of maintenance services free of charge to each customer based on the waiver language in the Equipment Schedule and hence that [REDACTED] simply did not have any payment for maintenance services to defer under Rev. Proc. 71-21.

Issue (1): Whether [REDACTED] received advance payments from its customers for twelve months of maintenance services.

Initially, we suggest that you obtain a wider sample selection of [REDACTED] Sales, Warranty and Maintenance Service Contracts. For example, you may wish to request the top ten dollar amount customer contracts. Additionally, you should inquire as to the particular names of the [REDACTED] personnel who: 1) determined to allocate a portion of the equipment's purchase price to the Maintenance Service Contract; 2) explained to [REDACTED] customers that a portion of the equipment's purchase price was going toward the Maintenance Service Contract. Likewise, obtain the individual names of the customer's buyers that [REDACTED] personnel negotiated the contracts with to facilitate potential interviews.

As the Tax Court has pronounced in determining the true sale price of goods for income tax purposes: "[T]he test to be applied, as in the interpretation of most business transactions is: What did the parties really intend, and for what purpose or consideration was the allowance actually made." *Pittsburg Milk Co. v. Commissioner*, 26 T.C. 707, 717 (1956). The Ninth Circuit in discussing *Pittsburg Milk* noted that "[T]he *Pittsburg Milk* doctrine has the obvious merit of reflecting economic reality. The seller would make no sale at the list price; only at the net price can he attract the customer. The net price is the true consideration, regardless of the parties' bookkeeping hypocrisies." *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d 670 (9th Cir. 1980), *affg.*, 69 T.C. 477 (1977).

In the case at hand, we believe it would be difficult to argue that the services [REDACTED] provided to its customers did not have an economic cost associated with them; therefore, we believe it would be difficult to argue that those services were provided free of charge. Although we do not have sufficient information at this time to determine the customers' true intention when they purchased computer equipment from [REDACTED],³ it appears clear that [REDACTED] intended to treat a portion of each customer's initial remittance as a payment for services. Further, even if [REDACTED] had represented to the customers that the services will be provided free of charge, that alone may not be sufficient to overcome any contrary statement by the customers or a statement by the customers that they would not have purchased the computer equipment without the accompanying services.

³The Equipment Schedule is not helpful as it only provides for the possibility that [REDACTED] would waive the charge for the first twelve months of maintenance services upon the happening of a future event.

Even if the services were not provided for free, that does not necessarily mean that the true cost of those services are as [REDACTED] contends or that the customers paid for the services in advance. As to the former, if [REDACTED] and the customers had not quantified what portion of any payment made is allocable to the payment for services, it may be possible to argue that the customers paid less than the amount [REDACTED] contends was paid for the services. As to the latter, the documents provided for the sample customer do not clearly show that the customer agreed to pay or paid for the services at any particular time, in advance of the services or otherwise. Further, given the Equipment Schedule provides for the possibility of [REDACTED] waiving the Maintenance Service Contract fees for the first twelve months, it follows that [REDACTED] will refund any advance payment made for the services if the customer had not defaulted on the Master Maintenance Agreement. To that end, we suggest that you have [REDACTED] provide documents evidencing the amount(s) of Maintenance Service Contract fees [REDACTED] either: refunded (if the fee was collected in advance and the customer was not in default on the Master Maintenance Agreement); or collected (if the fee was collected subsequent to the customer defaulting on the Master Maintenance Agreement).

Issue no. (2): If the customers made advance payments for services, whether [REDACTED] is eligible to defer the inclusion in gross income in taxable year one of such payments received under Rev. Proc. 71-21.

There are a number of requirements under Rev. Proc. 71-21 that a taxpayer must meet in order to defer income from the payment received in taxable year one for services to be performed by the end of taxable year two (the next succeeding taxable year)⁴ and additional requirements if the services to be performed are contingent services.⁵ Initially, we suspect the services [REDACTED] performs under its Maintenance Service Contracts may be contingent. After obtaining and reviewing the Maintenance Service Contract, you should be able to determine whether the services are contingent. For example, if [REDACTED] is required to perform repair services when the computer equipment fails under the Maintenance Service Contract, this would indicate the services were contingent. On the other hand, if [REDACTED] was only required to perform routine maintenance service, e.g. vacuuming the dust off the computer boards, on a fixed (e.g., monthly) basis under the Maintenance Service Contract, this would indicate the services were not contingent.

[REDACTED] manufactures and sells the computer equipment at issue. Hence, if the Maintenance Service Contract with respect to such computer equipment is a contingent service contract, [REDACTED] can defer the advance payments received pursuant to such contract only if it "offers to sell, lease, build, install or construct the property without such a

⁴Rev. Proc. 71-21 §§ 3.01, 3.02, 3.03, 3.08.

⁵Rev. Proc. 71-21 §§ 3.06, 3.07; see also *Signet Banking Corp. v. Commissioner*, 106 T.C. 117 (1996); and, *Barnett Banks of Florida Inc. v. Commissioner*, 106 T.C. 103 (1996).

contingent service agreement." Rev. Proc. 71-21 § 3.07. It is our understanding that [REDACTED] universally defers Maintenance Service Contract fees on all computer equipment it sells. Thus, we suspect [REDACTED] does not offer to sell, lease, build, install or construct its computer equipment without a contingent Maintenance Service Contract. If the facts as we suspect them are true, [REDACTED] would likely not be allowed to defer the income it currently defers for its Maintenance Service Contracts under Revenue Procedure 71-21.

We suggest that you verify our suspected facts by obtaining a complete copy of [REDACTED] Maintenance Service Contract, confirm that contingent services are performed pursuant to the Maintenance Service Contracts, confirm that all such computer equipment sold has a Maintenance Service Contract, i.e., that [REDACTED] universally defers Maintenance Service Contract fees on all computer equipment it sells.

Below is a listing of additional requirements under Rev. Proc. 71-21. and our analysis as to whether each element has been satisfied in this case:

1. Whether [REDACTED] received a payment in taxable year one for maintenance services from each customer and if so whether such payment was pursuant to an agreement (written or otherwise) between [REDACTED] and the customer as required by Rev. Proc. 71-21 § 3.02.

The payment issue is discussed in Issue 1 above. As stated, the documents provided for the sample customer do not clearly show that the customer agreed to pay or paid for the services at any particular time, in advance of the services or otherwise. You should ascertain or ask the customer whether it agreed to make and made such payment.

2. Whether all of the services under such agreement are required by the agreement, as it exists at the end of taxable year one, to be performed by [REDACTED] by the end of taxable year two as required by Rev. Proc. 71-21 §§ 3.02, 3.03.

To the extent the customer agreed to make an advance payment for maintenance services, the documents provided do not clearly show that all of the services required to be performed by [REDACTED] under any such agreement must be performed by the end of taxable year two. Review the Master Maintenance Agreement, and if possible, ask [REDACTED] customers to determine whether [REDACTED] timely performed the required services under the Maintenance Service Contracts.

3. If the agreement for services complies with all the above requirements and [REDACTED] properly deferred the income received in taxable year one but for any reason was unable to perform all the services under the agreement by the end of taxable year two, whether [REDACTED] included in gross income in taxable year two the amount allocable to the services not performed as required by Rev. Proc. 71-21 § 3.02.

To the extent there was an agreement that all maintenance services that had been

paid for in advance must be performed within the first twelve months, we do not have information as to whether any portion of such required services was performed after the end of taxable year two. However, we note that, to the extent that [REDACTED] did not defer any income from the payment received in taxable year one beyond taxable year two, this is not an issue.

4. Whether the services performed were pursuant to a warranty contract as prohibited by Rev. Proc. 71-21 § 3.08. *See also Standard Television Tube Corporation v. Commissioner*, 64 T.C. 238 (1975).

It does appear that [REDACTED] clearly warranted the computer equipment sold⁶ and also that it agreed to perform maintenance services in writing.⁷ Further, there does not appear to be anything statutorily that would prevent [REDACTED] from providing maintenance services pursuant to both a warranty and a service contract. See 15 U.S.C. § 1506; and, Cal. Civ. C. § 1794.4. However, given it is questionable whether [REDACTED] even received advance payments for maintenance services pursuant to agreements, it may be possible to argue that the services provided were in reality pursuant to warranty contracts if there is a substantial overlapping between the services provided under the warranties and Maintenance Service Contracts and all [REDACTED] customers receive the Maintenance Service Contracts as part of the purchase price of the computer equipment. Hence, you should confirm with [REDACTED] exactly what it claims is the warranty, versus what it claims is the Maintenance Service Contracts with respect to its computer equipment sold. You should also review the Maintenance Service Contracts and compare the services to be performed under those contract with the services to be performed under the warranties.

⁶Under the Commerce and Trade Code, a "written warranty" is defined in part as "any undertaking in writing in connection with the sale by a supplier of a consumer product to refund, repair, replace or take other remedial action with respect to such product in the event such product fails to meet the specifications set forth in the undertaking." 15 U.S.C. 2301(6). Under California law, an "express warranty" is created if the word "warranty" is used and is defined as a "written statement arising out of a sale to the consumer of a consumer good pursuant to which the manufacturer, distributor, or retailer undertakes to maintain the utility or performance of the consumer good or provide compensation if there is a failure in utility or performance..." Cal. Civ. C. 1791.2(a).

⁷Federal law and California law both define a "service contract" as a contract in writing to perform, over a fixed period of time or for a specified duration, services relating to the maintenance or repair of a consumer product. 15 U.S.C. 2301(8); Cal. Civ. C. 1791 (under California law, this term does not include a policy of automobile insurance).

If you have any questions, please contact Jeff Heinkel or John Chinnapongse of this office at 408-494-7859.

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